

VZCZCXRO2185  
RR RUEHGH  
DE RUEHIN #0221/01 0300857  
ZNR UUUUU ZZH  
R 300857Z JAN 07  
FM AIT TAIPEI  
TO RUEHC/SECSTATE WASHDC 3904  
RUEATRS/DEPT OF TREASURY WASHDC  
INFO RUCPDOG/USDOC WASHDC  
RUEHBK/AMEMBASSY BANGKOK 3566  
RUEHBJ/AMEMBASSY BEIJING 6291  
RUEHUL/AMEMBASSY SEOUL 8427  
RUEHGP/AMEMBASSY SINGAPORE 6795  
RUEHKO/AMEMBASSY TOKYO 8443  
RUEHML/AMEMBASSY MANILA 9936  
RUEHJA/AMEMBASSY JAKARTA 3997  
RUEHKL/AMEMBASSY KUALA LUMPUR 3673  
RUEHHI/AMEMBASSY HANOI 3223  
RUEHBY/AMEMBASSY CANBERRA 4441  
RUEHWL/AMEMBASSY WELLINGTON 1710  
RUEHHK/AMCONSUL HONG KONG 7523  
RUEHGH/AMCONSUL SHANGHAI 0774  
RUEHGZ/AMCONSUL GUANGZHOU 9954

UNCLAS SECTION 01 OF 04 TAIPEI 000221

SIPDIS

SIPDIS

STATE PLEASE PASS USTR  
STATE FOR EAP/RSP/TC, EAP/EP  
USTR FOR ALTBACH and Stratford  
USDOC FOR 3132/USFCS/OIO/EAP/WZARIT  
TREASURY FOR OASIA/LMOGHTADER  
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [ECON](#) [PINR](#) [TW](#)

SUBJECT: Taiwan 2007 Economic Outlook

#### SUMMARY

1. Consumer debt problems dampened consumption and excess manufacturing capacity reduced investment, but strong export growth still produced 4.4% real GDP growth in Taiwan in 2006. Export growth slowed in Q4 as higher interest rates reduced demand in major export markets. Economic growth in 2007 will depend on reviving domestic consumption. The collapse of a troubled business group in early January 2007 will have only a minor effect. Most observers anticipate about 4% GDP growth in 2007. END SUMMARY.

#### Performance in 2006

2. Exports accounted for 60% of Taiwan's GDP and 75% of GDP growth in 2006 with 13% y-o-y growth to US\$224 billion. Imports increased by only 11% to US\$202.7 billion, resulting in a 34.6% rise in Taiwan's trade surplus to US\$21.3 billion. However, y-o-y export growth in Q4 slowed dramatically and contributed to a decline in real GDP growth from 4.7% in H1 and 5% in Q3 to barely above 3% in Q4.

#### Weak Domestic Demand in 2006

3. Delinquent credit/cash card debt increased sharply in early 2006 dampening private consumption. Excess production capacity contributed to a decline in private investment in H1. However, strong export growth kept unemployment below 4%. Declining international petroleum prices helped reduce inflation from 2.3% in 2005 to below one percent in 2006.

#### Limited Economic Effect of Politics

¶4. Political uncertainty in Taiwan continued in 2006 as the opposition parties launched several moves to recall the President. Peaceful sit-ins and protests took place in September and lasted for almost two months. Taiwan's stock market defied the political uncertainty with higher prices and trading volume. However, many observers believe the political uncertainty contributes to a substantial undervaluation of Taiwan companies and stock prices.

#### Rapid Trade Growth Thanks to China

-----

¶5. Cross-Strait economic exchanges were a major factor behind Taiwan's export growth in 2006. Many Taiwan firms with export bases in China increased purchases of production inputs from Taiwan. Exports to Greater China (including Hong Kong) reached 40% of Taiwan's total exports in 2006. Greater China's sales to Taiwan reached 13% of Taiwan's total imports. Taiwan's approved investment in China grew from less than 50% of total approved outbound investment prior to 2004 to 71% in 2005 and 67% in the first 11 months of 2006.

#### Widening Income Disparity

-----

¶6. Globalization has contributed to a growing income disparity in Taiwan over the past three decades. Local economists note that a NT\$100 billion investment in a 12-inch wafer fab project will create a few thousand jobs for highly-skilled engineers and technicians, but only a few hundred jobs for less-skilled workers. The income of the richest 20% households was 4.3 times the income of the poorest 20% in the 1970s. The ratio increased steadily to 6.4:1 in 2001. Social welfare programs adopted in the 2000s have kept the

TAIPEI 00000221 002 OF 004

income gap from broadening. Taiwan launched an ambitious program in 2006 that aims to double per capita income to US\$30,000 and reduce the income ratio to 6:1 by 2015.

#### Domestic Demand to Drive 2007 Growth

-----

¶7. Economic growth relied more on domestic demand in Q4 of 2006. Imports of capital goods, an indicator of domestic investment, showed y-o-y growth of 8% in Q3 and 15% in Q4. Consumer goods imports increased from a monthly average of US\$1.27 billion in H1 to US\$1.30 billion in H2. The Directorate General of Budget, Accounting and Statistics (DGBAS) anticipates private consumption will accelerate from 1.5% growth in 2006 to 3.0% in 2007 while investment growth will increase from 0.15% in 2006 to 1.9% in 2007.

#### Planning Agency Estimates

-----

¶8. In December 2006, the Council for Economic Planning and Development (CEPD) estimated that Taiwan's 2007 GDP growth will rise to 4.6% from 4.4% in 2006 and that that expansion of domestic demand will contribute 65% of the island's 2007 real GDP growth, up from only 25% in 2006. CEPD projects growth of 9-10% in China that will offset the adverse effects of economic growth slowdown in the United States on exports. Major indicators forecast by CEPD with estimated 2006 figures in parentheses:

- Per capita GDP (US\$): 16,886 (15,573);
- Inflation rate (%): below 2% (0.68%);
- Unemployment rate (%): 3.9% (3.9%);
- Private consumption growth (%): 3.2% (1.5%);
- Private investment growth (%): 4.5% (0.15%).

#### Exports Could Be Better Than Expected

-----

¶9. Academia Sinica also predicts higher Taiwan economic growth in 2007 for two reasons: First, declining international petroleum prices will lower Taiwan's import costs and stimulate world demand. Second, the U.S. real estate sector has had a soft landing, keeping U.S. import demand strong. In addition, new products such as

Windows Vista, Office 2007, iPhone, and a new iPod series will bring Taiwan electronic firms large export orders.

#### Investment Growth More Than Expected

---

¶10. In early 2006, PowerChip planned a joint venture with Elpida Memory of Japan to build 12-inch wafer fabs in China, but the investment never materialized. Instead, these two companies decided to invest in Taiwan. DGBAS estimates the investment at NT\$450 billion (US\$13.8 billion). The unanticipated project will raise estimates of private investment growth and real GDP growth in 2007 in future economic forecasts.

#### Excess Liquidity Facilitates Foreign Acquisitions

---

¶11. To address excess liquidity, Taiwan's Central Bank began in 2006 to permit foreign investors to use credit obtained from local banks to finance direct investment projects. Carlyle Group, a U.S. private equity fund, announced in late November 2006 plans to use local funds to acquire Advanced Semiconductor Engineering (ASE), an M&A likely to materialize in early 2007.

#### Changing Attitudes Towards Investment in China

---

TAIPEI 00000221 003 OF 004

¶12. In a striking demonstration of changing views, Taiwan independence-minded economists previously strongly opposed to Taiwan investment in China have recently told AIT/T that without improved cross-strait ties, Taiwan will lose its competitiveness. These same economists recently told AIT/T that improved cross-strait ties could reduce business costs, increase efficiency, and ultimately lead to an increase in Taiwan's 2007 real GDP growth by up to a full percentage point, boosting GDP growth to nearly 5%.

¶13. Taiwan's Ministry of Economic Affairs (MOEA) in December 2006 authorized transfer of 0.18-micron semiconductor technologies to China, largely because the 0.18 technologies are no longer competitive with the more sophisticated chip production in Taiwan, and must be relocated to China and other less advanced chip production areas in order to maximize profits for the Taiwan companies that own them.

#### Taiwan's Changing Economy

---

¶14. Taiwan's economy has changed radically over the past two decades. The industrial sector's contribution to GDP declined from 45% in 1986 to 25% in 2005. Agriculture's share fell from 5.4% to 1.7%, while the service sector's share increased from 50% to 73%. DGBAS economists told AIT/T that as a developed economy Taiwan's real GDP growth was unlikely to exceed 5%.

#### Private Consumption to Grow Faster

---

¶15. Public consumption will remain sluggish in 2007 under the opposition-controlled legislature. However, private consumption, which accounts for 61.5% of GDP, will likely grow faster in 2007 than in 2006. Delinquent card debt problems have been mostly resolved. The recent large increases in real estate and stock prices will create a "wealth effect" which will stimulate spending in 2007. According to Academia Sinica, prices in Taiwan's real estate market have been rising since 2003. Taiwan's share price index increased 25% in H2 of 2006. Legislative elections in December 2007 will also stimulate spending during 2007. Chinese tourism to Taiwan will be another significant contributor to Taiwan's economy if it materializes in 2007, according to Academia Sinica.

#### Business Scandal and Collapse

---

¶16. Taiwan took over three problem banks in late December 2006 and early January 2007 when China Rebar Pacific Group (CRPG) collapsed following requests for reorganization of two affiliated firms. The business scandals have caused two senior financial regulators to step down, and stock price fluctuations. However, the aggregate debt of CRPG is less than one percent of Taiwan's banking system, and the effect on the economy is expected to be minor.

#### Forecast 2007 Growth

¶17. Latest 2007 economic growth rates forecast by selected Taiwan and foreign observers follow:

##### Foreign:

- Goldman Sachs: 4.5%;
- Credit Suisse Investment Consulting: 4.2%;
- Merrill Lynch: 4.0%;
- Nomura Securities: 3.7%;
- UBS Securities Investment: 3.5%;
- Morgan Stanley: 3.5%
- Lehman Brothers: 3.5%;

TAIPEI 00000221 004 OF 004

- Deutsche Securities: 3.5%;
- Mastercard: 1.3%.

##### Taiwan:

- DGBAS: 4.14%;
- Academia Sinica: 4.21%;
- Chunghua Institution for Economic Research (CIER): 4.13%;
- Taiwan Institute of Economic Research (TIER): 4.11%;
- Taiwan Research Institute (TRI): 4.08%.

YOUNG